90-1313

Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

ALBERT A. ROBIN, SHELI Z. ROSENBERG, DONALD S. CHISHOLM and EQUITY HOLDINGS, a partnership,

Petitioners,

v.

ARTHUR YOUNG & COMPANY, a partnership,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTIONS PRESENTED

1. Does compliance by a public accountant with Section 11 of the Securities Act of 1933 immunize him from liability under the anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5?

2. Does a public accountant aid and abet a securities fraud in violation of Section 10(b) and Rule 10b-5 when he gives his consent, as required by Section 7 of the 1933 Act, to the inclusion in a prospectus of his earlier-issued unqualified opinion knowing that the facts on which the unqualified opinion was based are no longer true and knowing that this information is not disclosed in the prospectus?

3. Was the Seventh Circuit correct when it held, contrary to the express language of Rule 9(b) of the Federal Rules of Civil Procedure, that a general averment of knowledge and intent was insufficient to allege the element of scienter in a case brought under Section 10(b) of the 1934 Act?

LIST OF ALL PARTIES

Petitioners (Plaintiffs) are Albert A. Robin, Sheli Z. Rosenberg, Donald S. Chisholm and Equity Holdings, a Partnership.

The Respondent (Defendant) is Arthur Young & Company.

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OPINIONS BELOW

The Opinion of the Court of Appeals for the Seventh Circuit, dated October 4, 1990, is reported at 915 F.2d 1120, and is reproduced in the Appendix at pp. 1-14. The Memorandum Opinion of the District Court, dated December 9, 1988 is unreported and is reproduced in the Appendix at pp. 18-27.

JURISDICTION

The judgment of the Court of Appeals for the Seventh Circuit was entered on October 4, 1990. Plaintiffs' Petition for Rehearing was denied on November 15, 1990. Appendix at p. 16. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND RULES INVOLVED

§ 11(a)(4), Securities Act of 1933, 15 U.S.C. § 77k(a)(4):

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

> (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him.

§ 10(b), Securities Exchange Act of 1934, 15 U.S.C. § 78j(b):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. 240.10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 9(b), Federal Rules of Civil Procedure:

(b) Fraud, Mistake, Condition of the Mind. In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

STATEMENT OF THE CASE

Plaintiffs, purchasers of 61,000 shares of stock in a public offering, sued defendant, the issuer's independent accountant, alleging that the prospectus was fraudulent and that defendant had aided and abetted the fraud in violation of Section 10(b) of the Securities Exchange Act (15 U.S.C. § 78j(b)) and Rule 10b-5 thereunder. Specifically, plaintiffs charged that the Securities Act of 1933 required audited financial statements to be included in the registration statement, and that defendant's written consent was necessary if its unqualified audit opinion was to be included (15 U.S.C. § 77g). Defendant gave its consent, knowing that the facts on which its unqualified opinion was based, when issued four months earlier, were no longer true, and that this information was not disclosed in the prospectus.

The trial court dismissed the amended complaint for failure to state a claim. The Seventh Circuit affirmed, holding that (i) there was no allegation of a manipulative or deceptive act as required by Rule 10b-5, since plaintiffs had not charged that the financial statements or the accountant's report in the prospectus were inaccurate; and (ii) plaintiffs' general averment that defendant acted with knowledge and intent was insufficient, as a matter of law, to allege scienter, notwithstanding the express language of Rule 9(b), Federal Rules of Civil Procedure. As to the first holding, the court said that defendant's consent to the use of its opinion with knowledge that the prospectus was false and misleading amounted to nothing more than "but-for causation", and did not constitute a manipulative or deceptive act (App. 9). With respect to the

second holding, the court said that allegations that defendant acted knowingly and intentionally were no more than "rote conclusions", and failed to "afford a basis for believing that plaintiffs could prove scienter." (App. 13).

REASONS FOR GRANTING THE WRIT

I.

THE SEVENTH CIRCUIT'S OPINION NULLIFIES *HERMAN & MACLEAN v. HUDDLESTON*, 459 U.S. 375 (1983).

In *Herman & MacLean v. Huddleston*, this Court held that investors injured by conduct of an accountant which violates Section 11 of the Securities Act of 1933 (15 U.S.C. § 77k(a)(4)) are not limited to the express remedy provided in that statute, but may maintain an action under § 10(b) of the 1934 Act (78 U.S.C. § j(b)) and Rule 10b-5, based on the same conduct. 459 U.S. at 387. The Court noted the "broad proscription against fraud" in § 10(b), and found that it would be undermined "if its scope were restricted by the existence of an express remedy under § 11." 459 U.S. at 386. The Court said that to limit an investor to the express remedy of § 11 would immunize an accountant from federal liability for conduct not reachable by § 11, *i.e.*, parts of a registration statement which the accountant did not prepare or certify, "even if the [accountant] engaged in fraudulent conduct while participating in the registration statement." 459 U.S. at 386, n22.

The Seventh Circuit's opinion undoes *Huddleston*. Even though the accountant had consented to the inclusion of its unqualified opinion in the prospectus knowing that the

facts on which the opinion was based were no longer true, the lower court declined to recognize this conduct as a manipulative or deceptive act. Such conduct, the court held, would constitute causation, but not deception. (App. 9). What the court said it was looking for, but did not find, was a claim that the financial statements, or defendant's audit report, included in the prospectus were inaccurate or misleading (App. 8). Such conduct, of course, is the precise conduct prohibited by § 11 of the 1933 Act. It would also violate § 10(b) of the 1934 Act. *Huddleston* at 382-383. But it is not the limit of § 10(b) liability. Any "fraudulent conduct while participating in the registration statement" is actionable. *Id.* at 386, n22.

The lower court did not follow *Huddleston*. It limited the accountant's 10(b) liability to conduct proscribed by § 11 of the 1933 Act, and characterized the accountant's other participating conduct as only "but-for causation." (App. 9). The characterization is anomalous. It suggests that deceptive conduct and causative conduct are necessarily mutually exclusive. They are not. While it is possible for innocent conduct to cause injury, it is equally possible, if not likely, that unlawful conduct will also cause injury. The same conduct can be unlawful and at the same time constitute "but-for causation."

The effect of the lower court's decision is to immunize public accountants from all § 10(b) liability in the Seventh Circuit unless the challenged conduct also would constitute a violation of § 11 of the 1933 Act. *Huddleston* cannot be read this way. This Court said that conduct which violates § 11 can also give rise to liability under § 10(b). The Seventh Circuit has now said that *only* conduct which violates § 11 can give rise to § 10(b) liability. *Huddleston* specifically rejected any such grant of immunity, 459 U.S. at 386, n22, and cannot be reconciled with the decision below.

II.

THE SEVENTH CIRCUIT'S HOLDING THAT THE ACCOUNTANT'S CONSENT WAS NOT A MANIPULATIVE OR DECEPTIVE ACT CONFLICTS WITH *U.S. v. ARTHUR YOUNG & COMPANY*, 465 U.S. 805 (1984).

Consenting to the inclusion in a registration statement of an unqualified opinion which the accountant knows is misleading must necessarily constitute a manipulative or deceptive act under § 10(b) and Rule 10b-5. Otherwise, the consent required by § 7 of the 1933 Act (15 U.S.C. § 77g) becomes meaningless.

Unlike other experts mentioned in the section (*e.g.*, engineer, appraiser), the accountant is in a unique position to prevent fraud. The public sale cannot proceed without audited financial statements in the prospectus, and the audit report cannot be included without the accountant's consent. If the accountant knows the prospectus is false and misleading in *any* respect, he has the power to prevent the fraudulent sale of securities merely by withholding his consent. If, notwithstanding this knowledge, he affirmatively consents, he engages in a manipulative or deceptive act which is a violation of § 10(b) and Rule 10b-5, even though it may not be reachable under § 11 of the 1933 Act.

The duty of fidelity which an independent accountant owes to public investors was spelled out in *U.S. v. Arthur Young & Company*, 465 U.S. 805, 817-818 (1984). The significance of an auditor's unqualified report, and the importance of investor confidence in the fidelity of the outside auditor, were specifically noted. 465 U.S. at 817-819, n13-14.[1]

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[1] *U.S. v. Arthur Young* was cited below and relied on by plaintiffs, but was not mentioned in the lower court's opinion.

The lower court here ignored these considerations.[2] Under its ruling, neither an accountant's unqualified opinion nor its duty of fidelity may be relied on by public investors. The Seventh Circuit's opinion allows an accountant to consent to the inclusion of his earlier-issued unqualified opinion in a prospectus, even if he knows that the facts on which that opinion was based are no longer true; knows that the prospectus does not disclose this information; and knows that he can prevent public distribution of the misleading prospectus merely by declining to provide the written consent required by § 7 of the 1933 Act. No liability would arise from this conduct under § 11 of the 1933 Act, because the portions of the prospectus "expertised" by the accountant, (*i.e.*, the financial statements and the auditor's report) were true on and as of the date reflected. *Huddleston*, 459 U.S. at 381, n11. The lower court has now held that, because there is no § 11 liability, there can be no § 10(b) liability. The accountant thus would ride free on this merry-go-round, while the defrauded investor is left without a remedy. This Court has already rejected any such result:

> "It would be anomalous indeed if the special protection afforded to purchasers in a registered offering by the 1933 Act were deemed to deprive such purchasers of the protections against manipulation and deception that §10(b) makes available to the persons who deal in securities." *Huddleston*, 459 U.S. at 383.

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[2] *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1044-1045 (11th Cir. 1986) adopted the teaching of *U.S. v. Arthur Young*, in recognizing the "special relationship of trust" between investors and accountants who certify financial statements. The lower court here expressly declined to follow *Rudolph*. (App. 11).

III.

THE SEVENTH CIRCUIT'S REQUIREMENT OF MORE THAN A GENERAL AVERMENT IN PLEADING INTENT, KNOWLEDGE AND SCIENTER, PATENTLY VIOLATES RULE 9(b) OF THE FEDERAL RULES OF CIVIL PROCEDURE.

Congress has delegated to this Court the power to make rules governing procedure for the district courts. 28 U.S.C. § 2072. Pursuant to this power, Rule 9(b) of the Federal Rule of Civil Procedure was adopted. It provides, in part: "Malice, intent, knowledge and other condition of mind of a person may be averred generally."

In an action under § 10(b), the complaint must allege that the defendant acted with *scienter*, *i.e.*, "intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976). Under Rule 9(b) this state of mind may be averred generally.

Plaintiffs' amended complaint alleged that defendant had knowledge that the prospectus was false and misleading, and knowingly and intentionally aided and abetted the violation of § 10(b), as the lower court acknowledged. (App. 12-13). These allegations were nevertheless deemed insufficient as "nothing more than rote conclusions." (App. 13). While agreeing that "the defendant's mental state need not be pleaded with particularity" *id.*, the court found that something more than the general averment specifically permitted under Rule 9(b) was required. The court then shifted from considering the sufficiency of the pleading to measuring the sufficiency of the evidence: "the complaint must still afford a basis for believing that plaintiffs could prove scienter." *Id.* The conclusion was that "the amended complaint as a whole provides no grounds for believing that plaintiffs could prove scienter." (App. 14).

It is impossible to reconcile the court's recognition that Rule 9(b) permits intent and knowledge to be pleaded generally, with its requirement that something more must also be pleaded. Apart from the impossibility of gleaning from the opinion just what that "something more" should be,[3] the court's requirement that facts in addition to the general averments permitted by Rule 9(b) be pleaded is patently violative of the rule which this Court promulgated, and calls for exercise of the Court's supervisory powers.

CONCLUSION

The lower court's limitation of liability under § 10b of the Securities and Exchange Act of 1934 decides a federal question in a way that conflicts with this court's decision in *Herman and Maclean v. Huddleston*, 459 U.S. 375 (1983). The lower court's decision that consent by an accountant to the inclusion in a prospectus of its earlier-issued unqualified opinion with knowledge that the facts on which the unqualified opinion was based are no longer true, and that this information is not disclosed in the prospectus, does *not* constitute a manipulative or deceptive act under § 10b of the 1934 Act and Rule 10b-5 there-

[3] Proof of scienter required in fraud cases is often a matter of inference from circumstantial evidence. *Huddleston*, 459 U.S. at 390, n30. The lower court here apparently was saying that the complaint must allege facts which, if true, would constitute circumstantial evidence from which a jury might infer that the defendant acted with knowledge and intent. No authority, other than the Seventh Circuit's prior opinion in *DiLeo v. Ernst & Young*, 901 F.2d 624 (1990), *cert. denied* ____ U.S. ____ (1990), was cited for this proposition.

under, decides a federal question in a way which conflicts with this court's decision in *U.S. v. Arthur Young*, 465 U.S. 805 (1984). The lower court's decision that general averments of knowledge and intent are nothing more than rote conclusions, and are insufficient to plead scienter under § 10(b), violates Rule 9(b) of the Federal Rules of Civil Procedure. The Petition for Writ of Certiorari should be granted to correct these errors.

Respectfully submitted,

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APPENDIX

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Nos. 88-3506 and 89-1052

ALBERT A. ROBIN, SHELI Z. ROSENBERG, DONALD S. CHISHOLM, AND EQUITY HOLDINGS, a partnership,

Plaintiffs-Appellants, Cross-Appellees,

v.

ARTHUR YOUNG & COMPANY, a partnership,

Defendant-Appellee, Cross-Appellant.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 87 C 6222—**Suzanne B. Conlon**, *Judge.*

ARGUED NOVEMBER 28, 1989—DECIDED OCTOBER 4, 1990

Before WOOD, JR., RIPPLE, and MANION, *Circuit Judges.*

WOOD, JR., *Circuit Judge.* In this securities action, plaintiffs appeal from the dismissal of their amended complaint under Fed. R. Civ. P. 12(b)(6) for failure to state a claim. Defendant cross-appeals from the denial of its motion to dismiss on limitations grounds.

I. FACTUAL and PROCEDURAL BACKGROUND

In early December 1983, plaintiffs Albert A. Robin, Sheli Z. Rosenberg, Donald S. Chisholm, and Equity Holdings bought 61,000 shares of Doctors Officenters Corporation ("DOC") at $9.00 per share pursuant to a December 7, 1983, prospectus. The prospectus stated in its summary that the purchase of its shares of common stock "is speculative and involves a high degree of risk." The prospectus contained DOC's financial statements, the most recent of which were dated July 31, 1983, as well as defendant Arthur Young & Company's ("Arthur Young") report on these financial statements. Arthur Young's unqualified report was dated August 19, 1983. In its report, Arthur Young stated that it had examined DOC's balance sheet at July 31, 1983, and December 31, 1982, and the related statements of operations, equity deficiency and changes in financial position for the seven months ended July 31, 1983, the year ended December 31, 1982, and the period December 7, 1981 (inception), to December 31, 1981. Arthur Young stated further in its report that it found the financial statements to present fairly DOC's financial position and that its examinations were made in accordance with generally accepted auditing standards and other necessary auditing procedures.

DOC was liquidated on February 26, 1985, and each shareholder received $2.72 per share. On July 13, 1987, plaintiffs filed suit against Arthur Young alleging violations of section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and rule 10b-5 (Count I), as well as common law fraud (Count II).[1] On May 4, 1988, the district court granted Arthur Young's motion to dismiss

[1] Plaintiffs also filed two other related suits. The first was against DOC, FMP (a medical partnership that owned DOC stock), and various officers and directors of DOC. The second was against the law firm that was counsel to DOC in the public offering and various officers and directors of DOC.

on the grounds that the applicable statute of limitations barred the action and that plaintiffs had failed to state a claim under federal securities laws.

Plaintiffs filed an amended complaint on June 16, 1988, which expanded the allegations in Count II. In their amended complaint, plaintiffs alleged that the primary violators knowingly and intentionally failed to disclose in the prospectus that Arthur Young's decision to issue its unqualified report was based on facts that were no longer true as of December 7, 1983, the date of the prospectus. Plaintiffs further alleged that Arthur Young aided and abetted the primary violators both by consenting to the use of its report in the prospectus with knowledge that the prospectus was false and misleading and by not withholding that consent until DOC had made adequate disclosure. Arthur Young again filed a motion to dismiss for the same reasons set out in its earlier motion—namely, that the action was barred by the statute of limitations and that plaintiffs had failed to state a claim for aiding and abetting under section 10(b) and rule 10b-5.

The district court, after denying Arthur Young's motion to dismiss based on the statute of limitations, dismissed the amended complaint for failure to state a claim under federal securities laws. The court held that plaintiffs' claims did not satisfy the Seventh Circuit requirements for aiding and abetting on the grounds that plaintiffs had not adequately alleged that Arthur Young had the requisite scienter and that Arthur Young had no duty to force DOC to make the disclosures plaintiffs claim should have been made.

Plaintiffs appeal from the dismissal of their amended complaint and Arthur Young cross-appeals from the denial of its motion to dismiss. We have jurisdiction under 28 U.S.C. § 1291 and now affirm.

II. ANALYSIS

A. *Statute of Limitations*

In its cross-appeal, Arthur Young renews its argument that actions under section 10(b) and rule 10b-5 should be governed by federal rather than state limitations periods. Specifically, Arthur Young argues that we should adopt the limitations period from section 13 of the Securities Act of 1933 and sections 9(e), 18(c), and 29(b) of the Securities Exchange Act of 1934 in place of the three-year limitation period provided by the Blue Sky law of Illinois, ILL. REV. STAT. ch. 121½, para. 137.13D. Under the relevant federal law, plaintiffs must file suit within one year after the discovery of facts constituting the violation, and in no event more than three years after the violation. Although plaintiffs brought this action more than three years after the sale of securities (the sale occurred on or around December 7, 1983, and this suit was filed on July 13, 1987), the state limitations period, unlike the federal limitations period with its three-year absolute bar, may be tolled by certain instances of fraud. The district court, applying the three-year Illinois statute and the federal tolling doctrine, rejected Arthur Young's claim that the action was time-barred, holding that the complaint raised factual issues as to whether the statute should be tolled and when the limitations period began to run.

Since this case was argued, the Seventh Circuit has ruled on the issue raised by Arthur Young in its cross-appeal. In *Short v. Belleville Shoe Mfg. Co.*, 908 F.2d 1385 (7th Cir. 1990), we expressly overruled our prior precedents to hold that actions under section 10b and rule 10b-5 are governed by the limitations period found in section 13 of the Securities Act of 1933: one year after the plaintiff discovers the facts constituting the violation and in no event more than three years after the violation. We left open all questions having to do with retroactive application of our decision in *Short*. *Id.* at 1038-39. Although application of section 13 would bar plaintiffs' suit in the present case, we do not reach the issue of whether *Short*

applies retroactively because plaintiffs have failed to state a claim for aiding and abetting.

B. *Aiding and Abetting Liability Under Section 10(b) and Rule 10b-5*

This circuit recognizes a cause of action for aiding and abetting violations of section 10(b) and rule 10b-5.[2] *E.g.*, *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir. 1990); *Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322 (7th Cir. 1989); *see also Schlifke v. Seafirst Corp.*, 866 F.2d 935, 946 (7th Cir. 1989) (citing cases). At the same time, this circuit has also questioned the propriety of implying such a cause of action from these securities provisions, *see Renovitch v. Kaufman*, 905 F.2d 1040, 1045 n.7 (7th Cir. 1990) (citing cases), and we observe that the Supreme Court has twice reserved decision on this issue. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191 n.7 (1975). Our recognition of aider and abettor liability is rooted in 20+ years' precedent, however, and we stand by this decision until the Supreme Court tells us otherwise. *DiLeo*, 901 F.2d at 628.[3]

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[2] Section 10(b) prohibits persons from using or employing any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of a security. 15 U.S.C. § 78j(b); rule 10b-5 makes it unlawful for any person, in connection with the purchase or sale of a security:

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

[3] Although Arthur Young argues on appeal that we should reconsider our position, it did not raise this argument before the district

(Footnote continued on following page)

Aider and abettor liability requires at a minimum that the alleged aider and abettor (1) commit one of the "manipulative or deceptive" acts prohibited under section 10(b) and rule 10b-5 (2) with the same degree of scienter that primary liability requires.[4] *E.g.*, *Renovitch*, 905 F.2d at 1045; *Schlifke*, 866 F.2d at 947; *LHLC Corp.*, 842 F.2d at 932; *First Interstate Bank of Nev. v. Chapman & Cutler*, 837 F.2d 775, 780 n.4 (7th Cir. 1988); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986). We consider each of these elements in turn.[5]

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[3] *continued*
court and we will therefore not consider it on appeal. *Patrick v. Jasper County*, 901 F.2d 561, 566 (7th Cir. 1990). At the same time we note that even had Arthur Young raised this argument below, reconsideration of our position would not be appropriate because plaintiffs' amended complaint fails to state a claim for aiding and abetting.

[4] To state a claim for a primary violation, the plaintiff must demonstrate that the defendant (1) made an untrue statement of material fact or omitted a material fact that rendered misleading the statements made (2) in connection with the purchase or sale of a security, (3) with the intent to mislead, and (4) which caused the plaintiff's loss. *Renovitch*, 905 F.2d at 1045 n.7; *Schlifke*, 866 F.2d at 943. Secondary liability or liability for aiding and abetting differs from primary liability in that secondary liability can attach to one who has not actually purchased or sold a security. *Renovitch*, 905 F.2d at 1045 n.7; *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 932 (7th Cir.), *cert. denied*, 109 S. Ct. 311 (1988). We assume for purposes of this appeal that primary violators committed the acts alleged in plaintiffs' amended complaint.

[5] Other courts have established additional requirements for aiding and abetting liability: (1) the existence of a primary violator; (2) knowledge by the aider and abettor of the primary violation; and (3) substantial assistance on the aider and abettor's part in perpetrating the primary violation. *Barker*, 797 F.2d at 496. It is unnecessary for us to analyze these additional factors, however, because plaintiffs' amended complaint does not allege even the minimal requirements of an aiding and abetting claim. *See Schlifke*, 866 F.2d at 947; *Barker*, 797 F.2d at 496.

1. *Manipulative or Deceptive Act*

Plaintiffs contend that the actions described in paragraphs 14 through 19 of their amended complaint constitute manipulative or deceptive acts proscribed by section 10(b) and rule 10b-5.

Paragraphs 14 through 16, under the heading "Active Conduct," allege that Arthur Young aided and abetted the primary violators by affirmatively consenting in writing to the use of its report in the prospectus with the knowledge that the prospectus was false and misleading. These paragraphs further allege that consent to the inclusion of the report in the prospectus was required before the registration statement could become effective, that Arthur Young knew its consent was required, and that without the registration statement, the securities could not have been offered to the public and the primary violators could not have defrauded the investors.

Paragraphs 17 through 19, under the heading "Passive Conduct," allege that Arthur Young discovered facts occurring between July 31, 1983, the date of DOC's financial statements, and before December 7, 1983, the date of the prospectus, which facts required adjustment of DOC's financial statements and/or financial disclosure by DOC.[6] The amended complaint alleges further that Arthur

[6] The amended complaint alleges that Arthur Young determined that its report would not include a going-concern qualification based on the facts that: (1) DOC was in the process of a public offering of securities that would generate approximately $30 million; (2) DOC had $500,000 remaining on its bank line of credit; (3) DOC had approximately $1 million of accounts receivable that could be used as collateral for any borrowings; and (4) DOC had additional cash available from private investors. According to the amended complaint, Arthur Young knew at the time the prospectus was issued that these facts were not true. The amended complaint further alleges that Arthur Young knew that although the prospectus stated that DOC had a cash overdraft of $123,000, $128,000 of collectible receivables outstanding, and $500,000 remaining under its bank line of credit, on October 31, 1983, DOC had

(Footnote continued on following page)

Young had a duty, under generally accepted auditing standards, to advise DOC to make adjustments in its financial statements and/or appropriate disclosure to prevent future reliance on its report and/or to prevent DOC's financial statements from being misleading as of the date of their reissuance in the December 7, 1983, prospectus. According to the amended complaint, in the event that DOC did not make the advised adjustments or disclosures, Arthur Young had the further duty under generally accepted auditing standards to (1) notify DOC that its report was not to be associated with the financial statements; (2) notify the appropriate regulatory agencies (including the SEC) that its report should no longer be relied on; (3) notify the investing public, as far as reasonably practicable, that its report should no longer be relied upon; and (4) to withhold or to withdraw consent to the use of its report in the prospectus. Finally, the amended complaint alleges that contrary to its duty to plaintiffs and other members of the investing public, Arthur Young failed to take any of the above-described actions.

Turning first to the "active conduct" described in paragraphs 12 through 16, we observe that plaintiffs have not alleged any problem with the audited financial statements of July 31, 1983, which are included in the prospectus and are the subject of Arthur Young's report. Nor is there any allegation that Arthur Young's report itself is incorrect; indeed, plaintiffs' counsel at oral argument acknowledged that the report was accurate when written. Rather, what plaintiffs allege is that the prospectus was false and misleading because circumstances had changed between the date of the report and the date of the prospectus, that Arthur Young knew this, and that had Arthur Young's

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[6] *continued*
an overdraft of $618,000, and on December 7, 1983, DOC had no available balance remaining on its bank line of credit. Finally, the amended complaint alleges that Arthur Young knew that DOC had been unable to generate sufficient cash between August 1, 1983, and December 7, 1983, to pay its liabilities when due.

report not been included in the prospectus, the registration statement could not have become effective.

Even assuming that Arthur Young knew that the prospectus was false and misleading, paragraphs 12 through 16 allege only that had Arthur Young not consented to the use of its report in the prospectus, the primary violators would have been unable to defraud plaintiffs. It is well settled in this circuit, however, that but-for causation is not sufficient to state a claim for aiding and abetting. *E.g., Renovitch*, 905 F.2d at 1047; *First Interstate Bank*, 837 F.2d at 779; *see also Schlifke*, 866 F.2d at 947. Because the connection alleged by plaintiffs between Arthur Young's consent to the use of its report in the prospectus and plaintiffs' loss on their investments amounts to nothing more than this but-for causation, the "active conduct" described in plaintiffs' amended complaint does not constitute a manipulative or deceptive act for purposes of aiding and abetting liability. *See Renovitch*, 905 F.2d at 1047; *First Interstate Bank*, 837 F.2d at 779.

Turning next to Arthur Young's "passive conduct," the amended complaint alleges that Arthur Young, knowing that certain changes occurred between the date of the financial statements and the date of the prospectus, nonetheless failed to carry out the duties described in paragraphs 17 through 19, which duties included advising DOC to make disclosures, making certain disclosures itself in the event of DOC's inaction, and withholding consent to the use of its report in the prospectus.

As we explained in *Barker*, when the manipulative or deceptive act is "the failure to 'blow the whistle,' the defendant must have a *duty* to blow the whistle." 797 F.2d at 496 (emphasis in original); *see also Schlifke*, 866 F.2d at 948 (quoting *Barker*); *LHLC Corp.*, 842 F.2d at 932 ("When the problem consists in keeping silence while the primary violator carries out the fraud, the plaintiff must show that the silent person had a legal duty to speak"); *First Interstate Bank*, 837 F.2d at 778 (quoting *Barker*). General duties to speak do not find their source in securi-

ties laws, *Basic Inc. v. Levinson*, 485 U.S. 224, 239 & n.17 (1988), but instead "must come from a fiduciary relation outside securities law." *Barker*, 797 F.2d at 496; *see also Schlifke*, 866 F.2d at 948.

Plaintiffs contend that the source of Arthur Young's duty is to be found in certain standards promulgated by the American Institute of Certified Public Accountants ("AICPA"), one of the main sources of professional standards for accountants.[7] Specifically, plaintiffs argue that sections 711.12, 560, and 561 of the AICPA Codification of Statements on Auditing Standards (1985) (the "Auditing Standards") impose on Arthur Young the duty to take the actions described in paragraphs 17 through 19 of their amended complaint.

In discussing the duty to disclose, we have said that there must be a legal duty to speak, *LHLC Corp.*, 842 F.2d at 932, and that state law will generally be the source of this duty. *DiLeo*, 901 F.2d at 628. Assuming, without deciding, the proposition that the failure to comply with the Accounting Standards constitutes a violation of state common law, the Auditing Standards set out the actions that plaintiffs allege Arthur Young should have taken.[8]

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[7] *See* Shroyer, *Accountants and the Dynamics of Duty*, 14 WM. MITCHELL L.R. 77, 82 n.3 (1988), for a list of treatises discussing these standards.

[8] Arthur Young argues that under the Auditing Standards, its only duty was to correct errors in the financial statements and that there is no duty to update information to the effective date of the prospectus. This is incorrect. Section 711 governs filings under federal securities statutes. Section 711.12, which deals with the accountant's response to subsequent events, states that if an accountant discovers subsequent events requiring adjustment or disclosure in the financial statements and the client refuses to make appropriate adjustment or disclosure, he should consider withholding consent to the use of his report in the prospectus and should follow the procedures in section 561.08-.09. Section 561.08 describes the actions that paragraph 17 of the amended complaint alleges Arthur Young should have taken with respect to notification to DOC, to regulatory agencies, and to the investing public.

The question then becomes whether an accounting firm's failure to comply with these professional standards constitutes a manipulative or deceptive act for purposes of aider and abettor liability.

Plaintiffs do not cite any cases that suggest that a failure to comply with the Auditing Standards may give rise to an action for securities fraud under section 10(b) and rule 10b-5. Instead, plaintiffs primarily rely on *Rudolph v. Arthur Andersen*, 800 F.2d 1040 (11th Cir. 1986), *cert. denied*, 107 S. Ct. 1604 (1987), a decision that substantially expands the scope of accountants' liability and one that we have previously declined to follow. *See Latigo Ventures*, 876 F.2d at 1327. We remain unpersuaded that accountants' liability should be expanded to this extent and thus decline again to adopt the position of the Eleventh Circuit.

Whether a lack of compliance with the Auditing Standards will expose an accounting firm to liability for aiding and abetting, while an interesting question, is one that we need not decide at this time. Even if we assume that a failure to comply with these professional standards constitutes a manipulative or deceptive act, this is not enough because plaintiffs have failed to allege that Arthur Young acted with scienter. And, unless the defendant acts with the requisite intent, there can be no liability for aiding and abetting, for it is the intent requirement that distinguishes an action for securities fraud from an action for negligence or malpractice. *See, e.g., Ernst & Ernst*, 425 U.S. at 199; *Barker*, 797 F.2d at 497. We thus conclude our discussion with an analysis of the scienter requirement.

2. *Scienter*

In *Ernst & Ernst v. Hochfelder*, the Supreme Court held that persons may be held liable for aiding and abetting under section 10(b) and rule 10b-5 only if they act with scienter. 425 U.S. 193 (1976). Scienter, as the Supreme Court defined it in this context, is the "intent to deceive, manipulate, or defraud." 425 U.S. at 193. Negligent conduct is thus not sufficient; aiders and abettors

must commit the proscribed act with the intent required for a primary violation. This circuit has held that the requirement of wrongful intent is satisfied by a showing of reckless conduct. *See, e.g., Rowe v. Maremont Corp.*, 850 F.2d 1226, 1238 (7th Cir. 1988); *Barker*, 797 F.2d at 495.

Turning to the amended complaint, the allegations having to do with Arthur Young's mental state occur in paragraphs 13, 16, and 20. Paragraph 13 alleges,

> At the time the prospectus was issued, Arthur Young had knowledge of each of the facts omitted from the prospectus, as hereinabove alleged, and had knowledge that the prospectus failed to disclose each of said facts. Alternatively, Arthur Young's lack of knowledge was due to a reckless disregard of the truth.

Paragraph 16 alleges, "Arthur Young, with knowledge that the prospectus was false and misleading, as hereinabove alleged, affirmatively consented to the use of its report in the prospectus." Finally, paragraph 20 of the amended complaint alleges,

> By virtue of the foregoing active and passive conduct, Arthur Young knowingly and intentionally aided and abetted the primary violators in the perpetration of the fraud upon plaintiffs and the members of the plaintiffs' class hereinabove alleged. Alternatively, Arthur Young's active and passive conduct . . . constituted an extreme departure from the standards of ordinary care which presented a danger of misleading buyers of DOC's securities that was either known to Arthur Young or so obvious that Arthur Young should have been aware of it.

Plaintiffs contend that these allegations are sufficient to satisfy the scienter requirement for aiding and abetting liability.

Although states of mind may be pleaded generally under Fed. R. Civ. P. 9(b), the rule requires plaintiffs to plead "with particularity" any "circumstances constituting fraud." *See also DiLeo*, 901 F.2d at 627. Assertions that

Arthur Young had knowledge that the prospectus was false and misleading and that Arthur Young knowingly and intentionally aided and abetted the primary violators are nothing more than rote conclusions. As we stated in *DiLeo*, while the defendant's mental state need not be pleaded with particularity, "the complaint must still afford a basis for believing that plaintiffs could prove scienter." *Id.* at 629. Plaintiffs' amended complaint fails to do this.

For example, the amended complaint alleges that Arthur Young consented to the use of its report in the prospectus while knowing that the prospectus was false and misleading. Yet it alleges no facts to show how Arthur Young knew that the basis for its decision to issue an unqualified report was no longer sound. How Arthur Young would have known, however, is important in this case. Arthur Young would not have discovered the events that negatively affected DOC's financial health during the course of a routine audit because they occurred between August 19, 1983, the date of Arthur Young's report and December 7, 1983, the date of the prospectus.[9] Although the Auditing Standards suggest certain procedures a firm should use to keep itself informed of events during this time lag,[10] plaintiffs do not allege that Arthur Young knew as a result of following those procedures.

Plaintiffs' claims that Arthur Young should have known that the prospectus was false and misleading also fail to allege scienter. While reckless conduct may satisfy the scienter requirement, bare allegations that Arthur Young

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[9] As we mentioned previously, plaintiffs do not contend that the report or the financial statements that were the basis of the report were false at the time they were completed.

[10] Section 711.10 of the Auditing Standards provides, for example, that an auditor should read the prospectus and should ask and obtain written representations from the relevant officers and others about whether any events have occurred that materially affect the financial statements or need to be disclosed so that the financial statements are not misleading.

should have known or that its knowledge was due to a reckless disregard of the truth are not sufficient to turn a possible negligence or malpractice action into an action for securities fraud. *See, e.g., Barker*, 797 F.2d at 496. Plaintiffs must provide more than conclusory allegations to satisfy rule 9(b)'s requirement that the circumstances of the fraud be pleaded with particularity.

Finally, the amended complaint as a whole provides no grounds for believing that plaintiffs could prove scienter. As we stated in *Barker*, "[i]f the plaintiff does not have direct evidence of scienter, the court should ask whether the fraud (or cover-up) was in the interest of the defendants. Did they gain by bilking the buyers of the securities?" *Barker*, 797 F.2d at 497. Here, as in *DiLeo*, there are no allegations that Arthur Young had anything to gain from any fraud by the primary violators. Although the amended complaint does allege that Arthur Young received $90,000 for its services to DOC, this is not sufficient to support an inference of scienter. As we explained in *DiLeo*, an accounting firm's "greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees [an accounting firm receives for its services] . . . could not approach the losses [the firm] . . . would suffer from a perception that it would muffle a client's fraud." 901 F.2d at 629.

We therefore conclude that plaintiffs have not adequately alleged that Arthur Young acted with the intent required to support a claim for aiding and abetting. The district court's dismissal of plaintiffs' amended complaint is

AFFIRMED.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

JUDGMENT – WITH ORAL ARGUMENT

Date: October 4, 1990

BEFORE: Honorable Harlington Wood, Jr., Circuit Judge
Honorable Kenneth F. Ripple, Circuit Judge
Honorable Daniel A. Manion, Circuit Judge

Nos. 88-3506 and 89-1052

ALBERT A. ROBIN, SHELI Z. ROSENBERG, DONALD S. CHISHOLM and EQUITY HOLDINGS, a partnership,

Plaintiffs-Appellants
Cross-Appellees

v.

ARTHUR YOUNG & COMPANY, a partnership,

Defendant-Appellee
Cross-Appellant

Appeals from the United States District Court
for the Northern District of Illinois, Eastern Division
No. 87 C 6222, Judge Suzanne Conlon

These causes were heard on the record from the above mentioned district court, and were argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the District Court in these causes appealed from be, and the same are hereby, AFFIRMED, with costs, in accordance with the opinion of this Court filed this date.

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

November 15, 1990.

Before

Hon. HARLINGTON WOOD, JR., Circuit Judge
Hon. KENNETH F. RIPPLE, Circuit Judge
Hon. DANIEL A. MANION, Circuit Judge

Nos. 88-3506 and 89-1052

ALBERT A. ROBIN, SHELI Z. ROSENBERG, DONALD S. CHISHOLM, AND EQUITY HOLDINGS, a partnership,

Plaintiffs-Appellants,
Cross-Appellees,

vs.

ARTHUR YOUNG & COMPANY, a partnership,

Defendant-Appellee,
Cross-Appellant.

Appeals from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 87 C 6222—Suzanne B. Conlon, *Judge.*

ORDER

On consideration of the petition for rehearing and suggestion for rehearing *in banc* filed in the above-entitled cause by plaintiffs-appellants on October 18, 1990, no judge in active service has requested a vote thereon, and all of the judges on the original panel have voted to deny a rehearing. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing be, and the same is hereby, DENIED.

UNITED STATES DISTRICT COURT
Northern District of Illinois
Eastern Division

JUDGMENT IN A CIVIL CASE

Albert A. Robin, et al.

v.

Arthur Young & Company

CASE NUMBER: 87 C 6222

☐ Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

☒ Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that defendant's motion to dismiss the amended complaint is granted. This cause is dismissed with prejudice. Judgment is entered in favor of defendant and against plaintiffs.

Date December 9, 1988

/s/ H. STUART CUNNINGHAM
Clerk

/s/ CLAUDIA M. FLAGG
(By) Deputy Clerk

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ALBERT A. ROBIN, SHELI Z. ROSENBERG, DONALD S. CHISHOLM and EQUITY HOLDINGS,	)	
Plaintiffs,	)	No. 87 C 6222
v.	)	Judge Suzanne B. Conlon
ARTHUR YOUNG & COMPANY,	)	
Defendant.	)	

MEMORANDUM OPINION AND ORDER

Plaintiffs purchased common stock of defendant Doctors Officenters Corporation ("DOC") in reliance on a prospectus issued on December 7, 1983. They filed this action against Arthur Young & Company ("Arthur Young"), the accounting firm that audited the financial statements contained in the prospectus.[1] On May 4, 1988, this court granted Arthur Young's motion to dismiss on the grounds that the action was barred by the applicable statute of limitations and for failure to state a claim under the federal securities laws. On June 16, 1988, plaintiffs filed an

[1] This case is related to 84 C 10798 and 85 C 8913. In 84 C 10798, plaintiffs sued DOC, FMP (a medical partnership that owned DOC stock) and six directors and officers of DOC. In 85 C 8913, plaintiffs sued the law firm of Katten, Muchin & Zavis (DOC's counsel in the public offering) together with six officers and directors of DOC.

amended complaint against Arthur Young, expanding the allegations in Count I.[2] Arthur Young moves to dismiss the amended complaint. For the following reasons, the motion is granted.

DISCUSSION

In ruling on a motion to dismiss under Fed.R.Civ.P. 12(b)(6), the court accepts all factual allegations of a complaint as true and views them, along with all reasonable inferences, in the light most favorable to the plaintiff. *Ellsworth v. City of Racine*, 774 F.2d 182, 184 (7th Cir. 1985), *cert. denied*, 475 U.S. 1047 (1986). The court is not bound by the legal characterizations that plaintiff attributes to the facts. *Republic Steel Corp. v. Pennsylvania Engineering Corp.*, 785 F.2d 174, 183-84 (7th Cir. 1986). The record is limited to the language of the complaint and matters of judicial notice; the complaint cannot be amended by plaintiff's brief in opposition to a motion to dismiss. *Id.* The complaint must be dismissed where it is clear that no relief could be granted under any set of facts consistent with the allegations in the complaint. *Hishon v. King & Spaulding*, 467 U.S. 69, 73 (1984).

I. Count I: Securities Fraud

Count I of the amended complaint purports to state a claim against Arthur Young under Section 10(b) of the

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[2] Arthur Young argues that this action should be dismissed for lack of subject matter jurisdiction because this court's order of May 4, 1988 dismissed the entire action. The order entered, however, dismissed the original complaint *without prejudice* and allowed plaintiffs an opportunity to cure pleading deficiencies enumerated in that order.

Securities Exchange Act of 1934 and SEC Rule 10b-5. Arthur Young argues that Count I is time barred and fails to state a claim for relief under federal securities laws.

Statute of Limitations

In its order of May 4, 1988 ("the order"), this court ruled that plaintiffs' federal securities fraud claims were governed by Illinois' three-year statute of limitations for state securities claims. Order at 13-14. Because plaintiffs' claims were time barred three years after the date of sale, or after December 6, 1986, the action against Arthur Young filed July 13, 1987 time barred. *Id.*

This court recognized that the statute of limitations could be tolled in two situations: (1) where fraud remains undiscovered, even though the defendant did not actively conceal it, and plaintiff exercised due diligence, and (2) where defendant takes affirmative steps to conceal the fraud after its commission. *Tomera v. Galt*, 511 F.2d 504, 510 (7th Cir. 1975). Count I of the original complaint did not allege sufficient facts to toll the three-year limitations statute on either basis. Order at 14-15.

In its motion to dismiss the amended complaint, Arthur Young again argues that the federal limitations periods contained in Section 13 of the Securities Act of 1933 and Sections 9 and 18(a) of the 1934 Act should apply, rather than the three-year Illinois statute. Arthur Young acknowledges that this would constitute a modification of the traditional approach and is based upon Supreme Court cases in areas other than securities law. Arthur Young's memo. at 2. As set forth in the order of May 4, 1988, the Seventh Circuit has consistently held that the Illinois three-year limitations statute for state law securities

claims applies to federal securities violations arising in Illinois. Order at 13. This court will not depart from that precedent.

Count I of the amended complaint contains expanded allegations. Paragraphs 21-30 set forth the events preceding plaintiffs' discovery of Arthur Young's allegedly unlawful conduct and support plaintiffs' claim that they exercised due diligence and reasonable care. If proven, the allegations raise factual issues as to whether the statute should be tolled and the date on which the limitations period began to run. Arthur Young's motion to dismiss Count I on the ground that the federal law securities claims are time barred is denied.[3]

Aiding and Abetting Securities Fraud

To state a claim for aiding and abetting violations of Section 10(b) and Rule 10b-5, plaintiffs must allege Arthur Young (1) committed a manipulative or deceptive act, or knew of an omission of material fact that made the prospectus misleading, and (2) had a duty to disclose this information to plaintiffs. *See Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495-96 (7th Cir. 1986). No one may be held liable without proof that he or she acted with scienter; aiders and abettors may be liable only if they have the same mental state required for primary liability. *Id.* A case against an aider and abettor may not rest on the bare inference that defendant must have had knowledge of certain facts; the claim must be supported

[3] Arthur Young requests that this court enter an order under 28 U.S.C. § 1292(b) to permit an interlocutory appeal of this issue. Because this order dismisses the entire case, Arthur Young's request for entry of a Section 1292(b) order is moot.

by evidence demonstrating that defendant has "thrown in his lot with the primary violators." *Id.* at 497. Absent direct evidence of scienter, the court will inquire whether the alleged fraud or concealment was in the interest of the defendants. *Id.*

Plaintiffs allege that Arthur Young actively assisted the primary violators by consenting to the use of its report in the prospectus. Plaintiffs predicate their aiding and abetting claim on Arthur Young's alleged knowledge of omissions or misrepresentations in the prospectus that made it misleading.[4] They attempt to allege scienter by stating

> At the time the prospectus was issued, Arthur Young had knowledge of each of the facts omitted from the prospectus, as hereinabove alleged, and had knowledge that the prospectus failed to disclose each of said facts. Alternatively, Arthur Young's lack of knowledge was due to a reckless disregard of the truth.

Amended Complaint ¶ 13.

Plaintiffs do not allege facts establishing Arthur Young's knowledge. The allegations of Arthur Young's active conduct—its consent to the use of its report—do not demonstrate that it "threw in its lot" with the alleged primary violators. Plaintiffs did not allege that Arthur Young had

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[4] Plaintiffs contend that paragraphs 14-16 of the amended complaint allege active conduct by Arthur Young sufficient to state an aiding and abetting claim under *Brennan v. Midwestern United Life Insurance Co.*, 417 F.2d 147, 154-55 (7th Cir. 1969). Plaintiffs' memo. at 3. *Midwestern* recognizes aider and abettor liability absent a duty to act only where there is clear evidence of scienter. *See IIT v. Cornfield*, 619 F.2d 909, 927 (2d Cir. 1980). The amended complaint does not allege sufficient facts to support scienter on the part of Arthur Young.

any interest in the allegedly fraudulent acts of the other defendants. Although knowledge may be averred generally, Fed.R.Civ.P. 9(b), plaintiffs' conclusory allegations that Arthur Young either had knowledge or recklessly disregarded the truth do not satisfy the scienter requirement of an aiding and abetting claim.

When the claimed violation of the securities act or rule is based on knowledge of an omission of a material fact, there must be a duty to disclose. *Baker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d at 495. Paragraph 17 of the amended complaint alleges a variety of duties that Arthur Young purportedly owed to plaintiffs. They maintain that both "generally accepted accounting standards" and *Escott v. BarChris Construction Corporation*, 283 F. Supp. 643 (S.D.N.Y. 1968), require accountants to investigate the financial condition of the issuer during the period between the date of its report and the date of the public offering and to take affirmative acts to adjust the financial statements in connection with post-report events. Plaintiffs maintain that the duties alleged are not promulgated in federal securities laws or regulations; they are derived from the American Institute of Certified Public Accountants Codification of Statements on Auditing Standards (1985) ("Auditing Standards"), Sections 711.12 and 561.08. Plaintiffs' memo. at 4.

The duties alleged cannot sustain a claim for aiding and abetting federal securities law violations. The Seventh Circuit has consistently refused to recognize a duty on the part of accountants to disclose an ongoing fraud perpetrated by a client. *See, e.g., Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d at 496 (law firm and accounting firm were not obliged to speak up concerning knowledge they may have had about ongoing fraud; their silence—even if morally culpable—did not have legal con-

sequences under the securities laws). In *LHLC Corporation v. Cluett, Peabody & Company*, 842 F.2d 928, 932-33 (7th Cir. 1988), the court ruled that an accountant for the seller of department stores had no duty to "blow the whistle" on its client when it later became apparent that the balance sheet it prepared did not accurately reflect the value of the seller's inventory. The discrepancy in the value of the inventory was not discovered until after the closing on the sale of the stores and after the accountant prepared the balance sheet. The court suggested, however, that the accountant's duty was not contingent upon the timing of the alleged fraud:

> Even if [the accountant] consulted with [seller/client] and reviewed the initial $7.9 million estimate before the closing, even if [seller/client's] estimate is fraudulent, [the accountant] had no obligation to blow the whistle. *Such an obligation could be imposed by state or federal law; perhaps one should be imposed; but none has been imposed.*

Id. (emphasis added). The bare allegation that the accountant had assured its client in advance that it would verify any estimate was insufficient to satisfy the particularity requirement of Fed.R.Civ.P. 9(b). *Id.* Accordingly, there was no basis for a claim against the accounting firm.

In addition to the absence of a duty under federal or state law, the duties purportedly imposed on Arthur Young under general accounting principles and common law do not include a duty to police the adequacy of disclosure in the entire prospectus for the period following preparation of financial statements. Plaintiffs contend that *Escott v. BarChris* imputes a duty on an accountant to investigate its client's financial condition between the date of the report and the public offering. Plaintiffs' memo. at 6. Courts have recognized that such a duty is limited to

monitoring material changes that would make the audited financial statement misleading:

> *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968) is authority for the view that an independent accountant's liability under section 11 is limited to those figures which he certifies, and does not extend to those financial statements contained in a prospectus which are identified as unaudited. In *Escott* the accountants who certified certain financial statements contained in the prospectus were not held responsible for those [interim] figures which they did not certify. (283 F. Supp. at 684).

Grimm v. Whitney-Fidalgo Seafoods, Inc., [1977-78 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 96,029, at 91,608 (S.D. N.Y. Dec. 4, 1973) (rejecting plaintiff's section 11 and Rule 10b-5 claims against Price Waterhouse based upon unaudited interim financial statements). *See also IIT v. Cornfield*, 619 F.2d 909, 927 (2d Cir. 1980) (Arthur Anderson had no independent duty to see to correction of portions of prospectus other than financial statements it prepared).

Moreover, the Auditing Standards require an independent auditor to extend his procedures beyond the date of its audit report only to inquire as to whether subsequent events have occurred "that, in the officers' or other executives' opinion, have a material effect on the audited financial statements included therein or that should be disclosed in order to keep those statements from being misleading." Auditing Standards § 711.10 b., at 458. The auditor's responsibility, therefore, is limited to responding to subsequent events and subsequently discovered facts that require adjustment in the financial statements or that may have affected its report had it been aware of those facts. *Id.* § 711.12, at 459.

Plaintiffs do not allege that the audited financial statements were misleading as to the period that they cover. Both common law and Auditing Standards extend an accounting firm's responsibility beyond the date of its report to ensure that the financial statements for the audited period are not misleading. The amended complaint alleges certain fraudulent events that occurred after the date of the financial statements concerning matters on which Arthur Young did not purport to render an opinion. *See* Amended Complaint ¶ 9.[5] Therefore, plaintiffs have not alleged an independent duty on the part of Arthur Young sufficient to support their aiding and abetting claim.

Count I fails to state a claim against Arthur Young.

II. Count II: Common Law Fraud

Count II of the amended complaint alleges common law fraud. Because Count I must be dismissed, this pendent state law claim will be dismissed. *United Mine Workers v. Gibbs*, 383 U.S. 715, 716 (1966).

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[5] Paragraph 9 of the amended complaint enumerates the following allegedly false and misleading aspects of the prospectus:

> . . . although on July 31, 1983, the Company had a cash overdraft of $123,000, it had $128,000 of collectible receivables outstanding and $500,000 remaining under the Company's $2.5 million bank line of credit

The prospectus allegedly was misleading because it failed to disclose that on October 31, 1983—over two months after the date of Arthur Young's report—DOC had an overdraft of $618,000 and on December 7, 1983, DOC had exhausted its bank line of credit.

CONCLUSION

Arthur Young's motion to dismiss the amended complaint is granted. This cause is dismissed with prejudice.

ENTER:

/s/ SUZANNE B. CONLON
Suzanne B. Conlon
United States District Judge

December 9, 1988

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ALBERT A. ROBIN, SHELI Z. ROSENBERG, DONALD S. CHISHOLM and EQUITY HOLDINGS, a partnership, Plaintiffs,	)	No. 87 C 6222
v.	)	Judge Suzanne B. Conlon
ARTHUR YOUNG & COMPANY, a partnership, Defendant.	)	

AMENDED COMPLAINT

Plaintiffs, by their attorneys, on behalf of themselves and a class of persons similarly situated, complain of defendant as follows:

JURISDICTION AND VENUE

1. Count I hereof is brought under Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) and Rule 10b-5 thereunder. This Court has jurisdiction of Count I under Section 27 of said statute (15 U.S.C. § 78aa). Count II is brought under the common law of fraud. This Court has jurisdiction of Count II under the doctrine of pendent jurisdiction.

2. All of the transactions complained of herein occurred in the Northern District of Illinois.

THE PARTIES

3. Plaintiffs Albert A. Robin, Sheli Z. Rosenberg and Equity Holdings, a general partnership, reside in Cook County, Illinois. Plaintiff Donald S. Chisholm is a resident of Ann Arbor, Michigan. On or about December 7, 1983, plaintiffs purchased an aggregate of 61,000 shares of Doctors Officenters Corporation (hereinafter "DOC") at a price of $9 per share pursuant to and in reliance on a prospectus issued by DOC on said date. Other members of plaintiffs' class also purchased shares of DOC at a price of $9 per share or higher, pursuant to and in reliance on said prospectus. A copy of said prospectus is attached hereto as Exhibit A, and incorporated herein by reference and made a part hereof.

4. Defendant Arthur Young & Company is a partnership with its principal office in New York, New York. It maintains an office in Chicago, Illinois and conducts business in the Northern District of Illinois. Said firm is engaged in business as certified public accountants. Arthur Young is one of the eight largest firms of independent Certified Public Accountants in the United States and one of the largest in the world, holding itself out to the public as having special expertise in auditing and extensive experience in connection with registrations under the Securities Act of 1933. The prospectus identified Arthur Young as experts in auditing and accounting, and contained Arthur Young's unqualified Report on the financial statements included in the prospectus. Arthur Young was paid $90,000 for its services.

NATURE OF ACTION

5. This action is brought by plaintiffs, on behalf of themselves and members of their class, against defendant

Arthur Young to recover damages resulting from Arthur Young's conduct in aiding and abetting a violation of the federal securities laws and the common law by DOC, its officers, directors, attorneys and controlling shareholder, all as more specifically alleged below.

OPERATIVE FACTS

6. At all times material herein DOC was a Delaware corporation, with its principal office in Mount Prospect, Illinois; Flashner Medical Partnership ("FMP"), an Illinois partnership, was the controlling shareholder of DOC, owning, directly or indirectly, 53% of the outstanding shares of DOC; Bruce A. Flashner was a director and officer of DOC and the controlling partner of FMP; Ronald van der Horst, Lawrence B. Levy, Sherry L. Dolce, David M. Turner and David R. Shevitz were the remaining officers and directors of DOC; Katten, Muchin, Zavis, Pearl & Galler (hereinafter "KMZ"), an Illinois partnership engaged in the practice of law, was counsel to DOC in connection with the preparation of the prospectus described below and all other matters relating to the public offering of securities thereunder (DOC and its aforesaid officers, directors, attorneys and controlling stockholder are hereinafter referred to as "the primary violators").

The Primary Violation

7. On December 7, 1983, DOC made a public offering of 805,000 shares of common stock of $9 per share, pursuant to a prospectus which the primary violators caused to be issued and distributed through the United States Mail to plaintiffs and members of the class. These shares constituted approximately 13% of DOC's outstanding shares. The remaining 87% was owned by DOC's insiders and

promotors who had paid an average price of 54 cents per share.

8. The prospectus contained the Report of Certified Public Accountants, dated August 19, 1983, signed by Arthur Young & Company (Exhibit A, p. 31). The Report stated that Arthur Young had examined the accompanying balance sheet of DOC at July 30, 1983 and December 31, 1982, and the related statements of operations, equity deficiency and changes in financial position for the seven months ended July 31, 1983, for the year ended December 31, 1982 and the period December 7, 1981 (inception) to December 31, 1981. The Report represented that the examinations were made in accordance with generally accepted auditing standards, including tests of the accounting records and such other auditing procedures as Arthur Young considered necessary in the circumstances. The Report was dated August 19, 1983 and was unqualified.

9. The prospectus was false and misleading in the following respects:

(a) Prior to issuing its aforesaid report on August 19, 1983, Arthur Young considered whether, because of DOC's operating losses and the necessity of seeking new sources of financing, the Report should contain a going-concern qualification, *i.e.*, language expressing the auditor's professional judgment that there was a substantial doubt about DOC's ability to continue in existence.

(b) Arthur Young determined that the Report would not include a going-concern qualification based on the facts that:

(i) DOC was then in the process of a public offering of securities which would generate approximately $30 million.

(ii) DOC had $500,000 remaining on its bank line of credit.

(iii) DOC had approximately $1 million of accounts receivable which could be used as collateral for any borrowings.

(iv) DOC had additional cash available from private investors.

(c) At the time the prospectus was issued, the facts described in subparagraphs (b)(i) through (iv) were no longer true.

(d) At the time the prospectus was issued, the primary violators, and each of them, knew that Arthur Young had considered whether to include a going-concern qualification in its Report dated August 19, 1983, and that Arthur Young had based its decision to issue an unqualified Report on the facts set forth in subparagraphs (b)(i) through (iv) above. At the time the prospectus was issued, the primary violators, and each of them, knew that the facts set forth in subparagraphs (b)(i) through (iv) were no longer true.

(e) The primary violators, and each of them, knowingly and intentionally failed to disclose in the prospectus that the decision of Arthur Young to issue its unqualified Report was based on the facts set forth in subparagraphs (b)(i) through (iv) above, and knowingly and intentionally failed to disclose in the prospectus that said facts were no longer true on December 7, 1983.

(f) At page 11, under the caption "Liquidity and Capital Resources", the prospectus stated that, although on July 31, 1983, the Company had a cash overdraft of $123,000, it had $128,000 of collectible receivables outstanding and $500,000 remaining under the Company's $2.5 million bank

line of credit. The primary violators, and each of them, knew but knowingly and intentionally failed to disclose in the prospectus that on October 31, 1983 DOC had an overdraft of $618,000; and that on December 7, 1983 DOC had no available balance remaining on its bank line of credit.

(g) The primary violators, and each of them, knew but knowingly and intentionally failed to disclose in the prospectus that DOC had no financial statements reflecting the results of operations of any period after July 31, 1983.

(h) The primary violators, and each of them, knew but knowingly and intentionally failed to disclose in the prospectus that from and after August 1, 1983, and as of December 7, 1983, DOC had been unable to generate sufficient cash to enable it to pay its liabilities when due.

10. The primary violators, and each of them, had knowledge of the facts omitted from the prospectus, as hereinabove alleged, and further had knowledge that said facts were not disclosed in the prospectus, and acted with intent to deceive. Alternatively, the primary violators acted with reckless disregard of the truth and of their duty of disclosure in failing to disclose said facts in the prospectus.

11. The conduct of the primary violators, and each of them, as hereinabove alleged, constituted a violation of Section 10(b) of the Securities Act of 1934 and Rule 10b-5 thereunder, and the common law of fraud.

12. On February 26, 1985 DOC was liquidated. Each shareholder of the Company received $2.75 per share.

Knowledge By Arthur Young
Of The Primary Violation

13. At the time the prospectus was issued, Arthur Young had knowledge of each of the facts omitted from the prospectus, as hereinabove alleged, and had knowledge that the prospectus failed to disclose each of said facts. Alternatively, Arthur Young's lack of knowledge was due to a reckless disregard of the truth.

Substantial Assistance By Arthur Young
In Aiding And Abetting the Primary Violators

Active Conduct

14. Pursuant to Section 7 of the Securities Act of 1933, and Items 25 and 26 of Schedule A thereunder, the registration statement which DOC filed with the Securities and Exchange Commission, and pursuant to which it proposed to offer its aforesaid securities to the public, could not have become effective unless the prospectus included audited financial statements. Pursuant to Section 7 of said Act, the Report of Arthur Young, as DOC's independent auditor, could not have been included in the prospectus unless Arthur Young affirmatively consented in writing to the use of its Report in the prospectus, and said consent was filed with the Securities and Exchange Commission. Unless Arthur Young affirmatively consented to the use of its Report, as aforesaid, the registration statement could not have become effective. In that event, the securities described therein, which were purchased by plaintiffs and members of the class, could not have been offered to the public, and no fraud could have been perpetrated by the primary violators.

15. Arthur Young knew that its consent to the use of its Report was necessary in order that the registration

statement become effective and the securities described therein be sold to the public.

16. Arthur Young, with knowledge that the prospectus was false and misleading, as hereinabove alleged, affirmatively consented to the use of its Report in the prospectus.

Passive Conduct

17. Pursuant to generally accepted auditing standards, (as promulgated by the American Institute of Certified Public Accountants), Arthur Young had a duty, in connection with the inclusion of its report in DOC's prospectus, to extend its auditing procedures with respect to subsequent events from the date of its August 19, 1983 Report up to the effective date of DOC's Registration Statement or as close thereto as was reasonable and practicable in the circumstances. Arthur Young had the further duty under generally accepted auditing standards, knowing that prospective purchasers of DOC's securities would rely on the financial statements of DOC with which its Report was associated, to advise DOC to make appropriate adjustments in such financial statements and/or appropriate disclosure of any subsequent events or subsequently discovered information requiring such adjustment or disclosure in order to prevent future reliance on its report and/or in order to make DOC's financial statements not misleading as of the date of their reissuance in DOC's prospectus on December 7, 1983. In the event that DOC failed or refused to make such adjustment or disclosure, Arthur Young had the further duty under generally accepted auditing standards: (i) to notify DOC that its Report must no longer be associated with the financial statements; (ii) to notify regulatory agencies having jurisdiction over DOC, including the Securities and Exchange Commission, that its Report should no longer be relied upon; (iii) to

notify the investing public, to the extent reasonably practicable, that its Report should no longer be relied upon; and (iv) to withhold or to withdraw its consent to the use of its Report in the prospectus.

18. The facts referred to in paragraph 9(c), (f), (g) and (h) above were events occurring subsequent to the date of DOC's financial statements, discovered by Arthur Young prior to December 7, 1983, which required adjustment of DOC's financial statements and/or financial statement disclosure by DOC.

19. Contrary to its duty to plaintiffs and other members of the investing public, as aforesaid, Arthur Young took no action to secure adjustment of DOC's financial statements or disclosure of such facts, and took no action to assure that its Report would no longer be associated with DOC's financial statements or to notify regulatory agencies or the investing public that its Report should no longer be relied upon. Arthur Young did not withhold or withdraw its consent to the use of its Report by DOC in the prospectus; instead, it consented to such use.

Aiding and Abetting with Scienter

20. By virtue of the foregoing active and passive conduct, Arthur Young knowingly and intentionally aided and abetted the primary violators in the perpetration of the fraud upon plaintiffs and the members of plaintiffs' class hereinabove alleged. Alternatively, Arthur Young's active and passive conduct hereinabove alleged constituted an extreme departure from the standards of ordinary care which presented a danger of misleading buyers of DOC's securities that was either known to Arthur Young or so obvious that Arthur Young must have been aware of it.

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